Docket No. 01-0432
Staff Exhibit 13.0

REBUTTAL TESTIMONY

OF

ROCHELLE LANGFELDT

FINANCE DEPARTMENT

FINANCIAL ANALYSIS DIVISION

ILLINOIS COMMERCE COMMISSION

Request for Approval of Revisions to Delivery Services Tariffs and for Approval of Delivery Services Implementation Plan for Residential Customers

ILLINOIS POWER COMPANY

DOCKET NO. 01-0432

NOVEMBER 2001

INTRODUCTION

1. Q. Please state your name and business address.

A. My name is Rochelle Langfeldt and my business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

2. Q. Are you the same Rochelle Langfeldt who previously testified in this proceeding?

A. Yes.

3. Q. What is the purpose of your rebuttal testimony?

A. The purpose of my testimony is to respond to the rebuttal testimony of Illinois Power Company ("IP" and "Company") witnesses Daniel L. Mortland (Company Exhibits 3.11 through 3.16) and Paul R. Moul (Company Exhibit 4.12 through 4.14). I will also respond to the direct testimony of Illinois Industrial Energy Consumers ("IIEC") witness Michael Gorman (IIEC Exhibit 2).

4. Q. Please summarize your findings and recommendations.

A. I recommend an 8.54% overall cost of capital for IP, as shown on Schedule 13.1. I adjusted the cost and balance of the transitional funding instruments ("TFIs") and the cost of long-term debt, which results in a slight increase from my initial recommendation of 8.53%[1].

[1] Staff Exhibit 4.0, Schedule 4.1.

RESPONSE TO MR. DANIEL L. MORTLAND

5. Q. Please respond to Mr. Mortland's assertion that the twelve-month period ending December 2001 that you used to measure IP's short-term debt balance is outside the test year and inconsistent with the measurement period Staff used in IP's initial delivery service rates proceeding.[2]

A. I calculated IP's short-term debt balance using the December 2000 through December 2001 period because it is centered in time at June 30, 2001, the measurement date for the other components in the capital structure. If IP had chosen a capital structure comprising average balances for 2000, then it would be proper to average the monthly short-term debt balances for calendar year 2000. However, IP chose a June 30, 2001 capital structure, which represents only a portion of the test year. In Docket No. 99-0534 (a MidAmerican Energy Company gas rate proceeding), MidAmerican Energy Company chose a capital structure measurement date, over an average capital structure, and the Commission accepted Staff's recommendation for a short-term debt balance that reflected six months of data within the test year and six months of data outside the test year. In the Order, the Commission stated, "the cost of

[2] IP Exhibit 3.11, p. 7.

capital, and therefore, its components, is not subject to the Commission's test year rules."[3]

6. Q. Please describe the adjustments you made to your TFI schedule.

A. I adjusted my original TFI schedule (Schedule 4.3) to reflect the required amortization and payment schedule from July 1, 2001 through maturity. In the internal rate of return ("IRR") calculation, shown on Schedule 13.3, I changed the payment frequency to monthly to reflect IP's monthly remittance of TFI collections to the issuing trust and I removed the un-amortized debt issuance costs and losses on debt reacquired with the proceeds of the TFIs (hereafter, collectively referred to as "debt costs"). My original IRR calculation included the unamortized debt costs, which would incorrectly allow IP to earn a return on the unamortized portion of these debt costs through maturity as though IP had to remit recovery of those debt costs to the trust on a monthly basis. Obviously, IP remits only amounts needed to cover the debt service costs of the TFIs to the trust, such as interest, principal repayment and reserve requirements. IP does not remit recovery of losses on reacquired debt to the TFI trust. Therefore, there is no valid reason for treating TFI-related debt costs differently than conventional (i.e., non-TFI) debt costs such as issuance expense, discount, premium, losses and gains, which are normally recovered through straight-line amortization.

[3]Order, Docket No. 99-0534, July 11, 2000, p. 17.

To calculate the embedded cost of the TFIs including debt costs, I subtracted the $42,520,784 balance of unamortized debt costs associated with the TFIs from the face amount outstanding of TFIs. To the $35,637,172 annualized cost of the TFIs excluding debt costs calculated with the IRR method,[4] I added the $5,680,851 annualized amortization of TFI-related debt costs. Based on these adjustments, as of June 30, 2001, the balance of the TFIs, including unamortized debt costs is $605,479,216 and the cost is 6.82%, as shown in Schedule 13.1.

7. Q. Besides modeling the debt costs as if they are remitted to the trust on a monthly basis, are there any other errors in the Company's TFI cost calculation?

A. Yes. IP incorrectly compounded the monthly TFI return. Annualizing the monthly TFI return requires multiplying the monthly return by twelve. In contrast, IP calculated the annual return by taking the monthly return to the twelfth power. The Company's calculation is incorrect because monthly utility rates are effectively set on the basis of the annual revenue requirement divided by twelve (not by taking the twelfth root of the annual revenue requirement).

[4]The annualized cost of the TFIs excluding related debt costs equals the product of the IRR on the TFIs of 5.50% and the $648 million face amount outstanding on the TFIs.

8. Q. Mr. Mortland revised the Company's long-term debt schedule to reflect the actual costs for the two variable-rate bond refinancings issued in May 2001. Do you agree with Mr. Mortland's adjustment?

A. Yes. I adjusted by long-term debt schedule to reflect the actual costs for the two variable rate bond refinancings, as shown on Schedule 13.2.

9. Q. Do you agree with Mr. Mortland that the current interest rate on Aaa-rated municipal bonds is an inappropriate proxy for the cost of IP's pollution control bonds?

A. Not entirely. Mr. Mortland indicates that from July 1, 2000, through June 30, 2001, the actual interest rates for IP's three variable rate pollution control bonds is slightly higher than the average rate for short-term, tax-exempt debt during the same period.[5] Nevertheless, the historical information Mr. Mortland provided in his rebuttal testimony is insufficient to support his proposed interest rate for the three variable rate pollution control bonds since the interest rate on these bonds changes weekly. To account for the cost difference between the pollution control bonds and municipal bonds, while still relying upon a current cost estimate, I added an amount equal to the midpoint of the range of actual interest rates on the variable rate debt issues, less the average rate from short-term tax-exempt debt during the same period, (i.e., 34.5 basis points) to cost of Aaa-rated municipal debt on August 23, 2001. This increases the cost of

[5] IP Exhibit 3.11, p. 5.

IP's variable rate debt to 2.82%, which also increases the embedded cost of debt to 6.86%, as shown on Schedule 13.2.

10. Q. What capital structure do you recommend?

A. I recommend adopting a June 30, 2001, capital structure comprised of 34.64% long-term debt, 19.17% TFIs, 5.46% short-term debt, 1.44% preferred stock (non-tax-advantaged), 2.99% preferred securities (tax-advantaged), and 36.30% common equity, as shown on Schedule 13.1.

Cost of Short-Term Debt and Variable Rate Debt

11. Q. According to Mr. Mortland, historical interest rates are preferable to spot interest rates for estimating the costs of short-term debt and variable rate long-term debt.[6] Please comment.

A. Historical averages are inappropriate estimates for future interest rates because security returns, including interest rates, closely approximate a type of time series called a random walk.[7] In a random walk, the "future steps or directions cannot be predicted on the basis of past actions."[8]

12. Q. Please explain why future interest rates cannot be predicted from a historical average.

[6] *Ibid.,* pp. 4 and 8.
[7] Burton G. Malkiel, *A Random Walk Down Wall Street,* Fourth Edition, Norton, 1985, pp. 132 and 146.
[8] *Emphasis added*, *Ibid.*, p. 16.

A. Interest rates must demonstrate a tendency to revert towards some mean value for historical averages to accurately depict future interest rates. Moreover, one must be able to determine the value of that mean. Thus, Mr. Mortland must demonstrate that 2000 represents the mean for short-term interest rates. He has not done so. The random walk implies that either the series exhibits no mean reversion or that its mean is not measurable.

13. Q. Has the Commission previously used a spot interest rate for the cost of short-term debt and variable rate debt?

A. Yes. In the Docket No. 99-0534 Order (a MidAmerican Energy Company gas rate proceeding), the Commission stated the following:

> "Based on the above arguments, it is clear that the cost of short-term and variable rate long-term debt should be measured using current interest rates instead of outdated historical averages and that MEC's cost of short-term and variable long-term debt are 5.57% and 3.80%, respectively. As previously discussed, the Courts found that the cost of capital, and its components are not test year items. Furthermore, the Commission does not accept MEC's contention that current interest rates are embedded rates. These current rates are, in the Commission's opinion, the best estimates of future rates."[9]

The Order cites seven other proceedings in which the Commission used the most recent spot rate or a forecasted rate to determine the cost of short-term debt and variable rate long-term debt.

[9]Order, Docket No. 99-0534, July 11, 2000, p. 22.

RESPONSE TO MR. PAUL R. MOUL

14. Q. Please evaluate Mr. Moul's rebuttal testimony.

A. Mr. Moul's rebuttal testimony contained nothing to change my opinion of IP's cost of common equity. In my judgment, the investor-required rate of return on common equity for IP's delivery service operations is 11.89%.

15. Q. Please respond to Mr. Moul's allegation that your recommended return on equity is too low and may be unacceptable to the financial community.

A. According to Mr. Moul, Value Line forecasts show that my Electric Sample and LDC Sample are expected to earn 14.3% and 13.4% on book common equity, respectively. He then compares these figures to my 11.89% recommended return on common equity and draws the conclusion that my recommendation does not conform to investor expectations for book equity.[10] This is essentially an argument for comparable earnings analysis since Mr. Moul uses return on book equity to evaluate estimates of the rate of return investors require. The flaws in this approach were addressed in my direct testimony.[11]

[10] IP Exhibit 4.12, pp. 2-3.
[11] Staff Exhibit 4.0, pp. 38-39.

16. Q. Mr. Moul disagrees with your representation of IP's common equity ratio as very close to the S&P BBB-rated ratios for both electric utilities and gas distribution companies.[12] Please respond.

A. In my direct testimony, I compared IP's June 30, 2001, capital structure to Standard & Poor's ("S&P") *Financial Medians for Electric* Utilities and *Financial Medians for Gas Distributors.*[13] In response, Mr. Moul states, "IPC has more debt and less equity in its capital structure which indicates that it has more financial risk than the electric utilities and gas distributors that were used for comparison."[14] As shown on Table 1, BBB-rated electric utilities have a mean common equity ratio of 39.84% and BBB-rated gas distribution utilities have a mean common equity ratio of 40.98%.[15,16] Table 1 also presents the June 30, 2001, common equity ratio for IP, and the mean common equity ratios for my Electric and LDC samples and Mr. Moul's Alliance RTO and Gas Distribution groups.[17]

[12]IP Exhibit 4.12, p. 22.
[13]Staff Exhibit 4.0, pp. 6-7.
[14]IP Exhibit 4.12, p. 22.
[15]*Standard & Poor's Financial Medians Electric Utilities*, www.ratingsdirect.com, July 7, 2000, and *Standard & Poor's Financial Medians Gas Distribution*, www.ratingsdirect.com, July 7, 2000.
[16]According to S&P, an obligor rated 'BBB' has adequate capacity to meet its financial commitments. Standard & Poor's *Utility Financial* Statistics, June 1999, p. 4. IP's credit rating is actually BBB+. Credit ratings may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories (i.e., 'AA' to 'CCC'). Standard & Poor's, *Corporate Ratings Criteria 2000,* p. 4.
[17]Standard & Poor's, *Utility Compustat.*

TABLE 1: Common Equity Ratios

Illinois Power Company	**36.49%**
S&P BBB-Rated Gas Distributors	40.98%
S&P BBB-Rated Electric Utilities	39.84%
Staff's Electric Sample	33.28%
Staff's LDC Sample	35.01%
Company's Alliance RTO Group	32.02%
Company's Gas Distribution Group	39.15%

Clearly, IP's common equity ratio is very close to the common equity ratios published by S&P, both of my samples, and both of Mr. Moul's samples. Further, I find Mr. Moul's argument that I should have used the median values for comparative purposes over the mean common equity ratio, since the source I used was titled *Financial Medians Electric Utilities* and *Financial Medians Gas Distribution*, to be simplistic. The word "median" in the title of my source does not signify that the only valuable data in the source is the median. The mean common equity ratio provides a sound basis for comparative purposes.

17. Q. Please respond to Mr. Moul's statement that, "IP divested all of its generation assets in the last four months of 1999, and in the ensuing 21 months, S&P revised IP's business profile from '7' to '6'."[18]

A. Mr. Moul's 21-month timeframe suggests that he is unaware of the date the business profile score was changed and the circumstances surrounding this change. In fact, IP's business profile rating was likely

[18]IP Exhibit 4.12, p. 23.

changed from "7" to "6" due to the sale of the Clinton Nuclear Power Plant ("Clinton") to AmerGen. On December 15, 1999, IP and Illinova had business profile scores of 7 and 8, respectively, with positive rating outlooks.[19] On December 16, 1999, IP announced the sale of Clinton to AmerGen.[20] On December 30, 1999, IP and Illinova had business profile scores of 6 and 7, respectively, with stable rating outlooks.[21] S&P raised both IP and Illinova's business profile scores following the sale of Clinton. IP's business profile rating was not raised because it transferred its generation assets to Illinova because if it were, Ilinova's business profile rating would not have been raised concurrently.[22] Since Illinova held the generation assets both before and after the transfer of those assets between Illinova subsidiaries, Illinova's business profile rating should not have changed. In contrast, Clinton was sold to an unaffiliated company, which would affect the business risk of both IP and Illinova.

[19]Standard & Poor's, *Global Utilities Rating Service Financial Statistics,* Twelve Months Ended June 30, 1999, p. 17.

[20]Press Release, "Clinton Power Station Now Under New Owner," December 16, 1999, www.illinoispower.com.

[21]Standard & Poor's, *Ratings Direct,* December 30, 1999.

[22]IP transferred its generation assets to Illinova on October 1, 1999. Illinois Power Company, Form 10-K for the year ended December 31, 2000, p. 12.

18. Q. Mr. Moul notes that nothing contained in your direct testimony alters the fact that IP's actual S&P business profile rating is "6."[23] Please comment.

A. As I stated in my direct testimony, IP's current business profile rating of "6" is inconsistent with the Company's primary business of electric transmission and delivery service operations. IP's current published business profile rating has not yet been raised to reflect the transfer of its generation assets. My opinion is based on the following facts: (1) S&P considers electric transmission and delivery services to be relatively low risk (i.e., a business profile score of 1 through 4) and generation operations to be relatively riskier (i.e., business profile score of 7 to 10)[24] and (2) once Commonwealth Edison and Ameren CIPS became electric transmission and distribution utilities, their business profile ratings were raised from 4 and 7 to 3 and 4, respectively.[25] Mr. Moul states, "I seriously doubt that investors have any knowledge of Ms. Langfeldt's preference in this regard [i.e., IP's S&P business profile score should be 4 since it divested its generation assets]. [26] While I agree that investors may not have knowledge of my personal preference in this regard, I also believe that investors are able to draw the same conclusions I do regarding IP's current published

[23]IP Exhibit 4.12, p. 23.
[24]Standard & Poor's, *Corporate Ratings Criteria 2000,* p. 17.
[25]Central Illinois Public Service Company's business profile rating was upgraded on October 2, 2000, and Commonwealth Edison Company's business profile rating was upgraded on October 23, 2000. Standard & Poor's, *Utilities & Perspectives,* October 2, 2000, and October 23, 2000.
[26]IP Exhibit 4.12, p. 23.

business profile and S&P's opinion that business profile scores for electric transmission and distribution utilities range from 1 to 4.

19. Q. How does IP's capital structure compare to the S&P benchmarks for utilities with business profile scores of 4?

A. As shown on Schedule 13.1, IP's debt ratio as of June 30, 2001, was 59.28%. According to S&P, the debt ratio for BBB-rated utilities with a business profile score of 4 ranges from 49.5% to 57.0% whereas the debt ratio for BBB-rated utilities with a business profile score of 6 ranges from 46.0% to 53.5%.[27] Obviously IP's debt ratio is closer to the benchmark for BBB-rated utilities with a business profile score of 4 than those with a business profile score of 6.

20. Q. Please respond to Mr. Moul allegation that some of the proxy companies that you selected are inappropriate proxies for IP since they are geographically remote from the Company.[28]

A. I limited my sample companies to those with similar S&P credit ratings to IP. Credit rating is a more comprehensive measure of risk than geographic location. In fact, according to S&P, geographic location is a rating consideration.[29] Therefore, using geographic location as a screening criterion, in addition to S&P credit rating, would count it twice. Moreover,

[27] Standard & Poor's, Ratings Direct, *Utility Financial Target are Revised,* June 18, 1999.
[28] IP Exhibit 4.12, p. 3.
[29] Standard & Poor's, *Corporate Ratings Criteria*, p. 20.

geographic location is only important as a risk measure to the extent it affects cash and earnings volatility, which credit ratings also reflect.[30]

21. Q. Due to their geographic location, Mr. Moul believes that the following companies are obvious choices for your LDC Sample: Laclede Gas, Nicor, and People's Energy.[31] Please explain why these companies were excluded from your LDC sample.

A. Laclede Gas is rated "AA-," Nicor is rated "AA," and Peoples Energy is rated "A+."[32] Thus, these companies do not meet the credit rating criterion that I established for my proxy companies.[33] Mr. Moul would have the Commission place more weight on geographic location, which is not a risk measure, than on credit ratings, which are risk measures.

22. Q. Please respond to Moul claims that the use of price data as of a single date "can produce an anomalous outcome because it is subject to the vagaries of the market" and "is dependent upon the time when the analyst decides to prepare his/her study."[34]

A. The market value of common stock equals the cumulative value of the expected stream of future dividends after each is discounted by the investor-required rate of return. New information becomes available every

[30] *Ibid.*, p. 26.
[31] IP Exhibit 4.12, pp. 3-4.
[32] Standard & Poor's, *Utilities & Perspectives,* October 22, 2001, p. 16.
[33] I removed companies with S&P credit ratings higher than "A-" and lower than "BBB" from my samples. Staff Exhibit 4.0, p. 13.
[34] IP Exhibit 4.12, pp. 4-5.

day, which causes investors to rethink their projections of future cash flows and the risk level of the company. Thus, only a current stock price will reflect all information that is available and relevant to the market. As to the "vagaries" of the market, I employed samples to minimize the effects of any such vagaries, as estimates for a sample as a whole are subject to less measurement error than individual company estimates. Mr. Moul claims that my use of spot market data is dependent upon the time when I decided to prepare my study. As Mr. Moul presumed, the date of my analysis, August 23, 2001, was chosen simply to provide the most recently available information possible while still allowing me time enough to complete my analysis and testimony by the September 12th deadline. Additionally, August 23rd was relatively stable in terms of price movements (i.e., less than 1.0% fluctuation either above or below the price level of the previous day). The only alternative to using spot market data is to use historical data, which is fraught with the problems discussed on pages 35 and 36 of my direct testimony.[35]

23. Q. Mr. Moul criticizes your DCF analysis because you did not include Value Line earnings per share ("EPS") forecasts.[36] Please comment.

A. Mr. Moul implies that any analysis that does not consider the Value Line EPS forecasts is doubtful. Mr. Moul states, "*to the extent that Value Line's*

[35] I do not believe that IIEC's witness Michael Gorman's use of a 13-week historical average of weekly high and low stock prices is an improvement over Mr. Moul's use of a six-month historical average stock price. IIEC Exhibit 2, p. 15.

earnings forecasts influence investor expectations, it is essential that those forecasts be incorporated into the DCF model." Mr. Moul does not, however, provide evidence of the extent to which Value Line's earnings forecasts influence investor expectations and fails to demonstrate that the Value Line EPS forecasts are universally employed. Furthermore, I am not aware of any evidence that the investment community regards as doubtful any analysis that does not consider the Value Line EPS forecasts. In fact, there is a very strong reason for not including the Value Line EPS forecasts. The methodology Value Line uses to normalize EPS forecasts is flawed in that the models employed are simplistic and mechanistic. If EPS was unusually high during the base period, the resulting forecasts will understate the long-term growth. Conversely, if EPS was unusually low during the base periods, the resulting forecasts will overstate the long-term growth. For example, IP Exhibit 4.13, Schedule 3, page 5 shows a Value Line growth rate estimate of 36.5% for American Electric Power, which is derived from the $4.75 earnings per share estimated for the period 2004-2006 and the $1.04 earnings per share in 2000.[37] The same report shows EPS of $2.81, $2.69 and $3.70 in 1998, 1999 and 2001, respectively.[38] Clearly the 2000 base year is anomalous. If 1998 had been the base year, the growth in EPS would have been approximately 8%. If 1999 had been the base year, the growth

[36]IP Exhibit 4.12, pp. 7-8.
[37]*Value Line,* American Elec. Pwr., July 6, 2001.
[38]*Ibid.*

in EPS would have been approximately 10%. If 2001 had been the base year, the growth in EPS would have been approximately 6%. Thus, Value Line's EPS forecasts are of questionable value as estimates of long-term sustainable growth.

24. Q. Please respond to Mr. Moul's statement that in addition to the IBES and Zacks forecasts, the consensus forecasts from First Call and Market Guide should also be employed in your DCF analysis.[39]

A. I disagree with Mr. Moul's statement. While the same arguments I present against the necessity of using Value Line earnings forecasts hold true for the earnings forecasts of both First Call and Market Guide, there is another reason that I did not employ these forecasts for my DCF analysis. When I asked Mr. Moul to provide a copy of any documents that describe the quality control measures[40] used by Market Guide and First Call in compiling consensus long-term growth forecasts, he responded that he is unaware of the quality control measures employed by any of the services that publish consensus analyst forecasts.[41] Thus, there is no evidence on whether Market Guide and First Call growth rates are suitable estimates of long-term sustainable growth. I do not share Mr. Moul's opinion that more is necessarily better with regard to growth estimates. It is critical that an analyst uses discretion when deciding what sources are most appropriate.

[39] *Ibid*., p. 8.

[40] "Quality control measures" include, but are not limited to, steps taken to ensure (1) consistency between analysts growth forecasts; (2) normalization of earnings estimates; and, (3) timeliness of estimates.

25. Q. Do you agree with IIEC witness Michael Gorman's reliance upon a non-constant-growth DCF model to estimate the cost of equity for IP's delivery service operations?

A. No. In conducting my analysis, I did not find that the growth rate estimates or the resulting DCF-derived cost of equity estimates were unreasonably high for the electric delivery service operations of IP. I do not believe that a non-constant DCF analysis would increase the accuracy of my cost of equity analysis given the level of subjectivity required in estimating the length of a transitional phase and the long-term growth rate.

26. Q. Mr. Moul criticizes your CAPM analysis because it does not include a size adjustment similar to that he included in his analysis.[42] Please comment.

[41] Company response to Staff data request RL 2.15.
[42] IP Exhibit 4.12, p. 9.

A. The problems inherent in Mr. Moul's proposed size adjustment are described in detail on pages 44-47 of my direct testimony. Further, a similar size-based risk premium, presented in Docket No. 97-0351 (Consumers Illinois Water Company rate proceeding), was rejected on the basis that the company witness failed to demonstrate that there is direct relationship between the size of a utility and its risk.[43] Mr. Moul has also failed to demonstrate such a relationship.

MR. MOUL'S COST OF EQUITY ANALYSIS

27. Q. Please respond to Mr. Moul's defense of his size adjustment.[44]

A. Mr. Moul argues that because Ibbotson's size-based premium study included utilities, the study applies to utilities. Unfortunately, his logic is not sound. Public utilities differ significantly from industrial companies. Just because a study includes some utility companies does not mean that the average results apply to utilities specifically. In fact, utilities, as a portion of total market capitalization, represent less than 10% of the New York Stock Exchange ("NYSE") and less than 4% of the S&P 500 Index.[45] Furthermore, the only evidence of which I am aware that pertains specifically to utilities indicates that no size-based premium is warranted for utilities.[46] Mr. Moul has failed to repudiate those findings.

[43] Amended Order, Docket No. 97-0351, June 17, 1998, p. 39.
[44] IP Exhibit 4.12, pp.29-31.
[45] *NYSE Fact Book 2000,* Listed Companies, p. 42, www.nyse.com, and Salomon Smith Barney, *Performance and Weights of the S&P 500, Second Quarter 2001,* Part III, Table B, p. 1.
[46] Staff Exhibit 4.0, pp. 45-46.

Mr. Moul also claims "the adjustment for the betas relates to regression bias and has nothing to do with the issue of size." If this statement is intended to counter my argument that a size-based adjustment should not be used in conjunction with adjusted betas, then Mr. Moul's logic is flawed. Ibbotson calculated size premiums based on a finite time period during which smaller companies realized returns in excess of that predicted by the CAPM using unadjusted ("raw") betas. Since the use of adjusted betas in the CAPM would result in higher predicted returns for utilities than if raw betas were used, then a size premium for utilities, if it existed, would be smaller if adjusted betas were substituted for raw betas Ä this in an incontrovertible result of mathematics. Thus, since Ibbotson bases its size premium on raw beta, it is inappropriate to add that size premium to an adjusted beta.

28. Q. Please respond to Mr. Moul's statement that, if Staff's position that Dynegy should serve as the basis for gauging the need for a size adjustment is correct, then IP's cost of equity should be determined using Dynegy's market data.[47]

A. It would be inappropriate to use Dynegy's market data to determine IP's cost of equity since rates should be based on investors' required rate of return on equity commensurate with the level of investment risk inherent in

[47] *Ibid*., pp. 29-30.

IP's electric delivery service operations.[48] On the other hand, size adjustments are not related to risk, but reflect liquidity or information costs.

29. Q. Mr. Moul disagrees with your opinion that Exelon Corporation and Ameren Corporation should be excluded from his Alliance RTO Group because mergers formed these companies within the past one to three years, particularly since you did not exclude American Electric Power Company and Puget Sound Power & Light from your Electric sample.[49] Please respond.

A. There are two reasons that Exelon Corporation and Ameren Corporation should be eliminated from Mr. Moul's Alliance RTO Group: (1) mergers formed these companies within the past one to three years yet Mr. Moul relies upon 1995-1999 market data for his fundamental risk analysis and (2) the 6-month average dividend yield Mr. Moul uses in his DCF analysis incorporates October 2000 stock prices and dividend payments although Exelon Corporation did not exist prior to October 21, 2000. On the other hand, I did not use any historical data with respect to my sample groups; thus, the fact that mergers formed these companies in the past is irrelevant.

[48] If Dynegy has a higher cost of equity than IP, then using Dynegy's market data to estimate IP's cost of equity would violate the Public Utilities Act. 220 ILCS 5/9-230.

[49] *Ibid*., p. 24.

30. Q. Please respond to Mr. Moul's statements that CMS Energy and Dominion Resources are viewed by investors principally as electric companies and that these companies' revenues from gas operations does not differentiate them from American Electric Power and Puget Energy, which were included in Staff's sample.[50]

A. The percentage of revenues from a utility's dominant business segment is an operating risk measure. CMS Energy and Dominion Resources generate only 30% and 50% of their revenues form electric sales, respectively. On the other hand, American Electric Power and Puget Energy generate 79% and 81% of their revenues from electric sales. Therefore, American Electric Power and Puget are more similar to IP's electric business with respect to operating risk, than CMS Energy and Dominion Resources.

31. Q. In defense of his use of historical data, Mr. Moul states, "most of the notable academic research has used historical data."[51] Please comment.

A. Of course, researchers study historical data. They certainly cannot study the future. The fact that academic researchers use historical data for "investigating and testing theories" is irrelevant to estimating a company's cost of capital. The investor-required rate of return is based on investors' expectations of the future, not the experience of the past.

[50] *Ibid*

32. Q. Mr. Moul claims that using historical data helps "avoid short-term fluctuations due to the vagaries of the market which can produce anomalous results."[52] Do you agree?

A. No. The "vagaries" of the market would not apply to growth rate projections or dividends. In fact, such "vagaries" would at best apply only to stock price information. Using historical data in pricing stocks presents many problems. First, as discussed previously, new information becomes available every day and investors rethink their projections of future cash flows and the risk level of a company. Any information reflected in historical prices, as well as new information that is not, is reflected in current prices. Thus, only a current stock price will reflect all information that is available and relevant to the market. Using historical data gives undue weight to information that may be obsolete. Second, the magnitude of historical risk premiums depends upon the measurement period used. Since there is no proven method for determining the appropriate measurement period to use, any measurement period chosen would be arbitrary. That is, use of historical data in determining required rates of return renders such estimates susceptible to manipulation.

[51] *Ibid*., p. 25.
[52] *Ibid.*

33. Q. Mr. Moul claims that using historical data captures expectations of future market returns.[53] Please comment.

A. As discussed above, historical data only captures information about the past, which may not continue into the future. The implication is that there exists some mean to which prices will revert. That implication is even more questionable for security returns since they approximate a random walk, which suggests no tendency of mean reversion.[54] Finally, even if securities data were mean reverting, there is no method for determining the true value of that mean. Consequently, sample means, which depend upon the measurement period used, are substituted. Thus, any measurement period chosen is arbitrary, rendering the results uninformative.

34. Q. Has the Commission ruled on the use of historical data in determining a company's cost of capital before?

A. Yes. As I stated in my direct testimony, in Docket No. 92-0357 (Iowa-Illinois Gas and Electric Company rate proceeding) and Docket No. 95-0076 (Illinois-American Water Company rate proceeding) the Commission rejected the use of historical data in determining a company's cost of capital.[55]

[53] *Ibid.,* p. 26.
[54] Burton G. Malkiel, *A Random Walk Down Wall Street,* Fourth Edition, Norton, 1985, pp. 132 and 146.
[55] Staff Exhibit 4.0, pp. 35-36, Order, Docket No. 92-0357, July 21, 1993, p. 66 and Order, Docket No. 95-0076, December 20, 1995, p. 70.

35. Q. Please respond to Mr. Moul's statement that his "[financial] leverage adjustment is not intended, nor was it designed, to address reasons that stock prices are different from book values."[56]

A. Mr. Moul's statement is problematical since his proposed financial leverage adjustment is used to justify higher rates based on the fact that market values have deviated from book values, yet it ignores the reasons for those differences. As explained in my direct testimony, the Commission should not, and has not, rewarded any utilities for alleged differences between their market and book values.[57]

36. Q. In his rebuttal testimony, Mr. Moul states that you do not dispute that using market values produces equity ratios of 54.25% and 66.96% for the Alliance RTO Group and Gas Distribution Group, respectively.[58] Please comment.

A. If the market value of IP's common equity is above that of its book value, it obviously follows that the resulting equity ratio would be higher when based on market values than when based on book values. Naturally, I did not dispute that simple mathematical principle. However, as I stated on page 42 of my direct testimony, using market values to calculate the equity ratio does nothing to change the risk level of a company.

[56]IP Exhibit 4.12, p. 29.
[57]Staff Exhibit 4.0, pp. 40-44.
[58]IP Exhibit 4.12, p. 29.

37. Q. Does this conclude your rebuttal testimony?

A. Yes.

Docket No. 01-0432
Staff Exhibit 13.0
Schedule 13.1

Illinois Power Company
Weighted Average Cost of Capital
June 30, 2001

Company Proposal

Description		Amount of Capital Stock	Capital Structure Ratio	Cost Rate	Weighted Rate
Long-Term Debt	$	1,093,971,947	34.93%	7.31%	2.55%
Transitional Funding Instruments		605,479,216	19.33%	7.75%	1.50%
Short-Term Debt		146,280,849	4.67%	4.53%	0.21%
Preferred Stock, Non-tax Advantaged		45,430,145	1.45%	5.05%	0.07%
Preferred Securities, Tax Advantaged		94,275,415	3.01%	8.63%	0.26%
Common Equity		1,146,130,943	36.60%	12.50%	4.57%
Total	$	3,131,568,515	100.00%		**9.17%**

Staff Proposal

Description		Amount of Capital Stock	Capital Structure Ratio	Cost Rate	Weighted Rate
Long-Term Debt	$	1,093,971,946	34.64%	6.86%	2.38%
Transitional Funding Instruments		605,479,216	19.17%	6.82%	1.31%
Short-Term Debt		172,517,989	5.46%	3.81%	0.21%
Preferred Stock, Non-tax Advantaged		45,430,145	1.44%	5.05%	0.07%
Preferred Securities, Tax Advantaged		94,275,415	2.99%	8.63%	0.26%
Common Equity		1,146,130,943	36.30%	11.89%	4.32%
Total	$	3,157,805,654	100.00%		**8.54%**

Illinois Power Company
Embedded Cost of Long-Term Debt
June 30, 2001

Docket No. 01-0432
Staff Exhibit 13.0
Schedule 13.2

	Debt Issue Type Coupon Rate (A)	Date Issued (B)	Maturity Date (C)	Original Principal Amount (D)	Face Amount Outstanding (E)	Unamortized Debt Discount or (Premium) (F)	Unamortized Debt Expense (G)	Carrying Value (H)	Coupon Interest Expense (I)	Amortization of Debt Discount or (Premium) (J)	Amortization of Debt Expense (K)	Total Expense (L)
14.5, 12	Loss on Reacquired Debt	9/1/96	9/1/16	$150,000,000	$ -	$ -	$9,900,760	$ (9,900,760)	$ -	$ -	652,800	$652,800
7.6	Loss on Reacquired Debt	12/1/93	10/1/01	35,000,000			24,067	(24,067)			24,067	24,067
7.625	Loss on Reacquired Debt	9/1/93	4/1/03	60,000,000			293,003	(293,003)			167,424	167,424
10.5	Loss on Reacquired Debt	5/1/91	9/1/04	50,000,000			517,081	(517,081)			163,284	163,284
8.625	Loss on Reacquired Debt	4/1/93	3/1/05	100,000,000			1,316,546	(1,316,546)			359,058	359,058
10.75	Loss on Reacquired Debt	7/1/91	11/1/28	150,000,000			4,955,710	(4,955,710)			181,308	181,308
11.625	Loss on Reacquired Debt	5/1/94	2/1/24	75,000,000			1,531,523	(1,531,523)			67,812	67,812
10.75	Loss on Reacquired Debt	7/1/91	12/1/24	150,000,000			2,493,353	(2,493,353)			106,476	106,476
9.875	Loss on Reacquired Debt	11/1/90	7/1/16	75,000,000			277,290	(277,290)			18,486	18,486
9.375	Loss on Reacquired Debt	3/1/93	2/1/23	125,000,000			7,214,454	(7,214,454)			334,260	334,260
7.625	Loss on Reacquired Debt	6/1/97	4/1/32	150,000,000			5,530,325	(5,530,325)			179,844	179,844
8.3	Loss on Reacquired Debt	7/1/87	4/1/17	33,755,000			3,696,935	(3,696,935)			234,726	234,726
8.875	Loss on Reacquired Debt	3/1/93	2/1/23	100,000,000			3,636,113	(3,636,113)			168,468	168,468
12	Loss on Reacquired Debt	1/1/88	11/1/12	75,000,000			327,392	(327,392)			28,884	28,884
7.5	Loss on Reacquired Debt	8/1/93	7/15/25	200,000,000			2,307,387	(2,307,387)			227,640	227,640
5.4	Loss on Reacquired Debt	3/1/98	3/1/28	52,455,000			1,160,800	(1,160,800)			43,530	43,530
7.375	Loss on Reacquired Debt	7/1/99	12/1/08	84,710,000			7,796,424	(7,796,424)			1,039,524	1,039,524
7.95	Loss on Reacquired Debt	12/1/98	12/1/08	72,000,000			3,216,543	(3,216,543)			428,868	428,868
8.75	Loss on Reacquired Debt	1/1/99	12/1/08	125,000,000			4,710,948	(4,710,948)			628,128	628,128
6.50%	New Mortgage Bond	8/1/93	8/1/03	100,000,000	100,000,000	268,846	29,057	99,702,097	6,500,000	128,778	13,918	6,642,696
6.75%	New Mortgage Bond	3/15/93	3/15/05	70,000,000	70,000,000	198,458	38,089	69,763,453	4,725,000	53,499	10,268	4,788,766
2.82%	PCB Series X Adjustable	5/1/01	3/1/17	75,000,000	75,000,000		2,466,626	72,533,374	2,111,250		157,316	2,268,566
	Remarketing & LOC Fees	5/1/01	3/1/17	75,000,000					415,092			415,092
5.70%	New Mortgage Bond	2/1/94	2/1/24	35,615,000	35,615,000	5,023,823	1,377,910	29,213,267	2,030,055	222,239	60,955	2,313,249
7.40%	New Mortgage Bond	12/1/94	12/1/24	84,150,000	84,150,000	658,523	3,034,149	80,457,328	6,227,100	28,096	129,452	6,384,648
7.50%	New Mortgage Bond	7/22/93	7/15/25	200,000,000	65,630,000	728,090	67,211	64,834,699	4,922,250	30,265	2,794	4,955,308
2.82%	PCB Series W Adjustable	5/1/01	11/1/28	111,770,000	111,770,000	409,530	4,576,333	106,784,137	3,146,326	14,969	167,270	3,328,565
	Remarketing & LOC Fees	5/1/01	11/1/28	111,770,000					564,256			564,256
2.82%	PCB Series P,Q,R Adjustable	4/10/97	4/1/32	150,000,000	150,000,000		2,669,229	147,330,771	4,222,500		86,733	4,309,233
	Remarketing & LOC Fees	4/10/97	4/1/32	150,000,000					301,726			301,726
5.40%	PCB Series S	3/6/98	3/1/28	18,700,000	18,700,000		520,245	18,179,755	1,009,800		19,494	1,029,294
5.40%	PCB Series T	3/6/98	3/1/28	33,755,000	33,755,000		525,471	33,229,529	1,822,770		19,690	1,842,460
6.25%	New Mortgage Bond	7/15/98	7/15/02	100,000,000	95,675,000	17,001	220,055	95,437,944	5,979,688	16,330	211,369	6,207,386
6.00%	New Mortgage Bond	9/16/98	9/15/03	100,000,000	90,000,000	79,373	338,778	89,581,849	5,400,000	35,900	153,227	5,589,127
7.50%	New Mortgage Bond	6/29/99	6/15/09	250,000,000	250,000,000	293,401	1,876,203	247,830,396	18,750,000	36,839	235,574	19,022,413
	TOTAL ENDING BALANCE				1,180,295,000	7,677,045	78,646,009	1,093,971,946	68,127,812	566,914	6,322,646	75,017,372

Sources: Revised IP Exhibit 3.3 and IP Exhibit 3.11
Illinois Power Company 2000 Form 21 ILCC Annual Report
Company Response to Staff data requests RL 1.01-RL 1.03 and RL 5.02
BondResources, www.bondresources.com/Municipal/Rates/Daily, August 23, 2001

Embedded cost of long-term debt = 6.86%

Illinois Power Company
Transitional Funding Instruments
June 30, 2001

	Date (A)	Beginning Balance (B)	Interest Rate (C)	Interest Expense (D)	Cash Outflow (E)	Ending Balance (F)
1	June-2001				$ 648,000,000	
2	July-2001	$ 648,000,000	0.4583%	$ 2,969,764	(10,188,658)	$ 640,781,106
3	August-2001	640,781,106	0.4583%	2,936,680	(10,188,658)	633,529,129
4	September-2001	633,529,129	0.4583%	2,903,445	(10,188,658)	626,243,915
5	October-2001	626,243,915	0.4583%	2,870,057	(10,093,078)	619,020,894
6	November-2001	619,020,894	0.4583%	2,836,954	(10,093,078)	611,764,770
7	December-2001	611,764,770	0.4583%	2,803,699	(10,093,078)	604,475,392
8	January-2002	604,475,392	0.4583%	2,770,292	(9,997,498)	597,248,186
9	February-2002	597,248,186	0.4583%	2,737,170	(9,997,498)	589,987,858
10	March-2002	589,987,858	0.4583%	2,703,896	(9,997,498)	582,694,257
11	April-2002	582,694,257	0.4583%	2,670,470	(9,901,918)	575,462,809
12	May-2002	575,462,809	0.4583%	2,637,329	(9,901,918)	568,198,219
13	June-2002	568,198,219	0.4583%	2,604,035	(9,901,918)	560,900,336
14	July-2002	560,900,336	0.4583%	2,570,589	(9,806,028)	553,664,898
15	August-2002	553,664,898	0.4583%	2,537,429	(9,806,028)	546,396,299
16	September-2002	546,396,299	0.4583%	2,504,118	(9,806,028)	539,094,389
17	October-2002	539,094,389	0.4583%	2,470,653	(9,709,908)	531,855,134
18	November-2002	531,855,134	0.4583%	2,437,476	(9,709,908)	524,582,702
19	December-2002	524,582,702	0.4583%	2,404,147	(9,709,908)	517,276,940
20	January-2003	517,276,940	0.4583%	2,370,664	(9,613,788)	510,033,817
21	February-2003	510,033,817	0.4583%	2,337,469	(9,613,788)	502,757,498
22	March-2003	502,757,498	0.4583%	2,304,122	(9,613,788)	495,447,833
23	April-2003	495,447,833	0.4583%	2,270,622	(9,517,668)	488,200,787
24	May-2003	488,200,787	0.4583%	2,237,409	(9,517,668)	480,920,528
25	June-2003	480,920,528	0.4583%	2,204,044	(9,517,668)	473,606,905
26	July-2003	473,606,905	0.4583%	2,170,526	(9,421,088)	466,356,343
27	August-2003	466,356,343	0.4583%	2,137,297	(9,421,088)	459,072,552
28	September-2003	459,072,552	0.4583%	2,103,916	(9,421,088)	451,755,379
29	October-2003	451,755,379	0.4583%	2,070,381	(9,324,248)	444,501,512
30	November-2003	444,501,512	0.4583%	2,037,137	(9,324,248)	437,214,401
31	December-2003	437,214,401	0.4583%	2,003,740	(9,324,248)	429,893,893
32	January-2004	429,893,893	0.4583%	1,970,191	(9,227,408)	422,636,676
33	February-2004	422,636,676	0.4583%	1,936,931	(9,227,408)	415,346,199
34	March-2004	415,346,199	0.4583%	1,903,519	(9,227,408)	408,022,310
35	April-2004	408,022,310	0.4583%	1,869,954	(9,130,568)	400,761,696
36	May-2004	400,761,696	0.4583%	1,836,679	(9,130,568)	393,467,807
37	June-2004	393,467,807	0.4583%	1,803,251	(9,130,568)	386,140,490
38	July-2004	386,140,490	0.4583%	1,769,670	(9,033,728)	378,876,432
39	August-2004	378,876,432	0.4583%	1,736,379	(9,033,728)	371,579,083
40	September-2004	371,579,083	0.4583%	1,702,936	(9,033,728)	364,248,291
41	October-2004	364,248,291	0.4583%	1,669,339	(8,936,888)	356,980,741
42	November-2004	356,980,741	0.4583%	1,636,032	(8,936,888)	349,679,885
43	December-2004	349,679,885	0.4583%	1,602,572	(8,936,888)	342,345,570
44	January-2005	342,345,570	0.4583%	1,568,959	(8,840,048)	335,074,481
45	February-2005	335,074,481	0.4583%	1,535,636	(8,840,048)	327,770,069
46	March-2005	327,770,069	0.4583%	1,502,160	(8,840,048)	320,432,181
47	April-2005	320,432,181	0.4583%	1,468,531	(8,743,208)	313,157,504
48	May-2005	313,157,504	0.4583%	1,435,191	(8,743,208)	305,849,488
49	June-2005	305,849,488	0.4583%	1,401,699	(8,743,208)	298,507,979

50	July-2005	298,507,979	0.4583%	1,368,053	(8,644,822)	291,231,210
51	August-2005	291,231,210	0.4583%	1,334,704	(8,644,822)	283,921,091
52	September-2005	283,921,091	0.4583%	1,301,202	(8,644,822)	276,577,471
53	October-2005	276,577,471	0.4583%	1,267,546	(8,545,102)	269,299,915
54	November-2005	269,299,915	0.4583%	1,234,193	(8,545,102)	261,989,007
55	December-2005	261,989,007	0.4583%	1,200,688	(8,545,102)	254,644,592
56	January-2006	254,644,592	0.4583%	1,167,028	(8,445,382)	247,366,239
57	February-2006	247,366,239	0.4583%	1,133,672	(8,445,382)	240,054,529
58	March-2006	240,054,529	0.4583%	1,100,163	(8,445,382)	232,709,309
59	April-2006	232,709,309	0.4583%	1,066,500	(8,345,662)	225,430,147
60	May-2006	225,430,147	0.4583%	1,033,140	(8,345,662)	218,117,624
61	June-2006	218,117,624	0.4583%	999,626	(8,345,662)	210,771,589
62	July-2006	210,771,589	0.4583%	965,960	(8,245,942)	203,491,607
63	August-2006	203,491,607	0.4583%	932,596	(8,245,942)	196,178,261
64	September-2006	196,178,261	0.4583%	899,079	(8,245,942)	188,831,398
65	October-2006	188,831,398	0.4583%	865,409	(8,146,222)	181,550,584
66	November-2006	181,550,584	0.4583%	832,041	(8,146,222)	174,236,403
67	December-2006	174,236,403	0.4583%	798,520	(8,146,222)	166,888,701
68	January-2007	166,888,701	0.4583%	764,846	(8,046,502)	159,607,045
69	February-2007	159,607,045	0.4583%	731,474	(8,046,502)	152,292,017
70	March-2007	152,292,017	0.4583%	697,950	(8,046,502)	144,943,465
71	April-2007	144,943,465	0.4583%	664,271	(7,946,782)	137,660,954
72	May-2007	137,660,954	0.4583%	630,896	(7,946,782)	130,345,068
73	June-2007	130,345,068	0.4583%	597,367	(7,946,782)	122,995,654
74	July-2007	122,995,654	0.4583%	563,685	(7,846,200)	115,713,139
75	August-2007	115,713,139	0.4583%	530,310	(7,846,200)	108,397,249
76	September-2007	108,397,249	0.4583%	496,781	(7,846,200)	101,047,830
77	October-2007	101,047,830	0.4583%	463,099	(7,744,500)	93,766,429
78	November-2007	93,766,429	0.4583%	429,729	(7,744,500)	86,451,658
79	December-2007	86,451,658	0.4583%	396,205	(7,744,500)	79,103,363
80	January-2008	79,103,363	0.4583%	362,528	(7,642,800)	71,823,092
81	February-2008	71,823,092	0.4583%	329,163	(7,642,800)	64,509,455
82	March-2008	64,509,455	0.4583%	295,645	(7,642,800)	57,162,300
83	April-2008	57,162,300	0.4583%	261,973	(7,541,100)	49,883,173
84	May-2008	49,883,173	0.4583%	228,613	(7,541,100)	42,570,686
85	June-2008	42,570,686	0.4583%	195,100	(7,541,100)	35,224,686
86	July-2008	35,224,686	0.4583%	161,434	(7,439,400)	27,946,720
87	August-2008	27,946,720	0.4583%	128,079	(7,439,400)	20,635,399
88	September-2008	20,635,399	0.4583%	94,571	(7,439,400)	13,290,570
89	October-2008	13,290,570	0.4583%	60,910	(7,337,700)	6,013,780
90	November-2008	6,013,780	0.4583%	27,561	(7,337,700)	(1,296,359)
91	December-2008	(1,296,359)	0.4583%	(5,941)	1,302,300	(0)

Quarterly IRR = 0.4583%
Annual IRR = 5.50%

Column (D) = Columns (B) * (C)
Column (F) = Column (B) + Column (D) + Column (E)

Source: Company response to Staff data request FIN-10